Goldman SMALL CAP RESEARCH

The Goldman Guide

VOLUME 3 | ISSUE 26 | JANUARY 2, 2013

INSIDE THIS ISSUE:

Confession of an Investment Idiot p.3

S&P 500 vs. Russell 2000 p.3

KEY TAKEAWAYS

⇒ *Near term overhang is gone*

⇒ *Retail investors return and drive market higher*

⇒ *Valuations are attractive*

⇒ *Some big names are very cheap*

⇒ *I am a moron*

⇒ *Chart shows Russell 2000 beats the S&P 500*

KEY STATISTICS

Index	Close	2012
DJIA	13,104	7.3%
S&P 500	1426	13.4%
NASDAQ	3020	15.9%
Russell 2K	849	14.6%

(figures are rounded)

3 Reasons to Buy Stocks

Despite all of the gyrations in 2012, the market rocked. And it really ended the year with a bang. Did anyone really think the politicians wouldn't pass something to avert the fiscal cliff?

Please.

But, enough of the past. 2012 is behind us and for some, it is a good thing. Here are 3 reasons to buy stocks:

1. Goodbye fiscal cliff, hello more investment dollars.

Our take on the fiscal cliff compromise is anything but positive. How can substantially higher taxes for most of Americans with little in the way of spending cuts and a rise in the debt limit be good? Still, while some market watchers may bitch and moan about it, the truth is that we really won't feel it for a while. In the meantime, with record low interest rates and the average dividend yield around 2.7% on the S&P 500, growth stocks should rule the roost. Market bears would say that this low dividend yield is a classic "tell" that the market is overvalued, but they offer no real substitutes for investment capital and anemic returns.

It is amazing that the market did as well as it did last year, and it is even more remarkable that the gains of the last few years have not been broadly enjoyed by retail investors as mutual fund outflows have been heavy and consistent ($275B in total) since late 2008 and the market has roared.

Institutionally, the best place for investment dollars is equities. Low P/E S&P 500 stocks and high growth stocks will likely be big winners, along with out of the box investment categories and real estate. These returns will be further bolstered by the retail investor finally showing up late to the dance, which could take stocks to an overvalued scenario later in the year with retail investors once again holding the proverbial bag.

3 Reasons to Buy Stocks (cont'd)

2. The January Effect may get the publicity but valuations are pretty favorable.

History is on our side with the January Effect as even the S&P 500 Index has been up 13 of the past 20 Januarys. Last year's losers, low P/E stocks, along with high dividend plays, and stories typically rule the day. We think that January through April should be pretty strong as fundamentals bear out favorable valuations. Right now, the estimated 2013 P/E on the S&P 500 is around 13.8x and will probably peak with a gain of 15%, reaching a P/E of 16x as money pours in. The Russell 2000 Index is trading with an estimated 2013 P/E of around 16x, but the expected growth rate is much higher, which is why we think small stocks will be the better plays in the short and long term. For example, using the IBES long term EPS growth rate forecasts, the Russell 2000 2013 price-earnings/long term growth ratio (PEG) is less than 1.3x compared to the slower growth PEG of 1.45x for large caps. This is an unusual situation that will likely right itself quickly which could then be followed by a large cap rally.

3. The economy is still poor and monetary policy sucks, but it may not be getting worse.

Let's face it. Unemployment is bottoming, real estate prices and activity are on the rise, China is pulling out all the stops to continue growing at a fast clip and the European headache may not be so bad anymore. We expect to see some real, albeit muted, revenue growth in 2013. 1Q13 GDP could be better than expected fueling a strong Q2, at least for a while.

Oil stocks, which really haven't done much should start to climb , along with a modest rise in oil prices. Those with longer term horizons will continue to procure and invest in gold, along with other commodities.

Is Apple (NASDAQ—AAPL) cheap? You tell me. It is trading under 11x FY13 EPS which by the way is a September year. Not that I am necessarily advocating the following stocks, but they are worth a watch list inclusion. Ford (NYSE –F) trades under 9x 2013 EPS and Dell (NASDAQ—DELL) trades around 10x this year and next year's EPS.

Any good news on auto sales should have a big effect on Ford and once the mess at Dell bottoms, a bounce is likely to occur. Unless the PC is dead. It is funny. We are all about watching and using very small devices (mobile devices like cell phones and tablets) and big-ass HDTV sets. If you believe Dell management can right the ship, it could get interesting. Otherwise, Dell could be stuck right in the middle with nowhere to go and expertise in only declining technology sectors.

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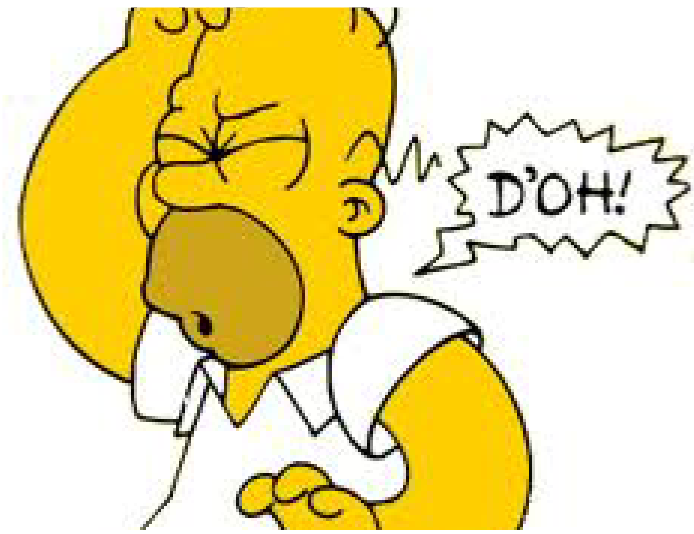
Confession of An Investment Idiot

Here is a little known secret. Like many of you, I am not very heavily invested in the market. Like you, I make mistakes, even when I know better. But what happened to me on Monday, December 31, 2012 is really pissing me off. And it is all self-inflicted. Here's the story.

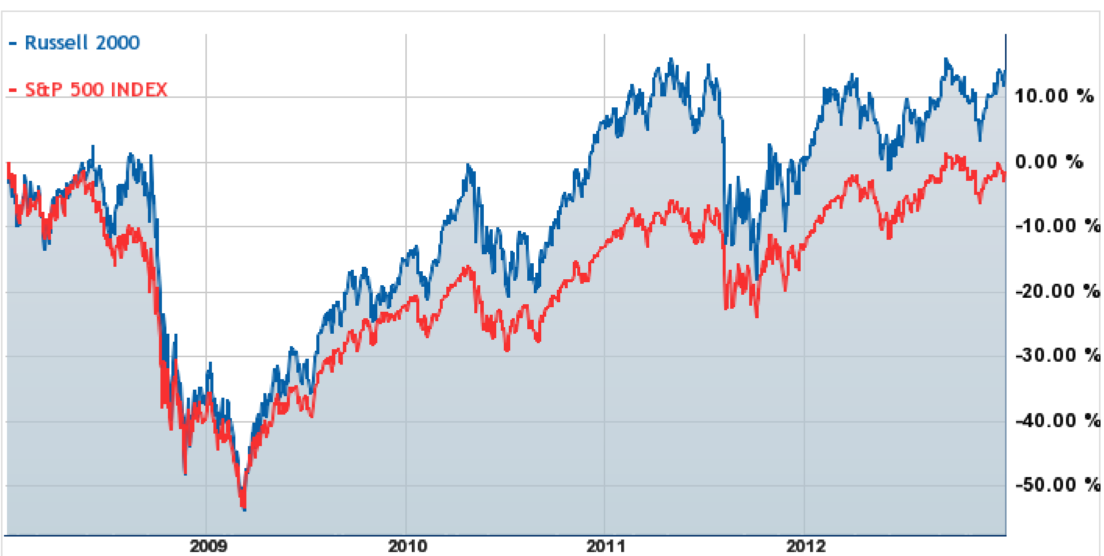
I have been waiting for the market to sell-off in response to the inevitable screw-ups in talks surrounding the fiscal cliff. Specifically, I planned to use the sell-off on Friday, December 28th, to take a real flier and buy a short-term, out-of-the-money call option on the Russell 2000 Index. A total gamble that could cost me the whole investment. Despite my strong intention, I got sidetracked and never made the trade. Needless to say, I could have made a boatload of cash.



Timing is everything folks, and if you are planning to execute a trade, go ahead and do it. Don't be a schmuck like me, thinking there is no sense of urgency necessary. Prudence is important but staying the course of your plan is even more important in succeeding as a trader or investor.

I leave you with a chart that is worth a thousand words. Check out the performance of the Russell 2000 Index vs. the S&P 500 Index over the past 5 years, courtesy of the CBOE. The trends are the same but the performance of the small cap barometer is easily seen.

Until next week...



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Analyst Certification

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